

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Promote Policy
and Program Coordination and Integration in
Electric Utility Resource Planning.

Rulemaking 04-04-003
(Filed April 1, 2004)

**ASSIGNED COMMISSIONER'S RULING PROVIDING GUIDANCE ON NEXT
STEPS FOR POTENTIAL CAPACITY MARKET DEVELOPMENT**

Summary

This ruling is issued to inform parties that the Commission staff is evaluating the prospect of moving forward with a capacity market approach to enhance the resource adequacy program currently under development in this proceeding. Although this evaluation is not being carried out in Phase 2 of the resource adequacy requirements (RAR) portion of this proceeding, it is my expectation that the issues being addressed in Phase 2 will be resolved in a way that would not foreclose our movement toward a capacity market in the near future.

The California Independent System Operator (CAISO) has a pivotal role in implementing and enforcing RAR. With that in mind, I have asked Commission staff to examine the New York demand curve approach to capacity market development. This approach seems to provide an example of how to manage market power concerns while providing for locational procurement and a foundation for new investment. The New York approach also may also serve as a model for defining state and federal jurisdictional roles and responsibilities. All of this requires further investigation before consideration by this Commission.

2. Background

D.04-01-050 adopted key policies for RAR that are applicable to the three major investor-owned utilities, energy service providers (ESPs), and community choice aggregators (collectively, load serving entities or LSEs). In adopting these policies, the Commission stated that it was “providing a framework to ensure resource adequacy by laying a foundation for the required infrastructure development and assuring that capacity is available when and where it is needed.” (D.04-01-050, p. 11.)

D.04-10-035, the *Interim Opinion Regarding Resource Adequacy*, was issued in this docket to provide definition and clarification with respect to the RAR policy framework adopted in D.04-01-050. Among other things, D.04-10-035 instituted a year-round 100% “month-ahead” obligation as an overlay to the 90% “year-ahead” obligation for the summer months. The month-ahead obligation requires a showing that the remaining 10% of resources have been acquired for each of the five summer months and that all of the necessary resources have been acquired for the other seven months. D.04-10-035 identified a series of implementation issues for Phase 2 that are earmarked for a June decision.

While D.04-10-035 established a capacity-based obligation with associated locational procurement, deliverability, and must-offer requirements, the Commission identified resource tagging and trading as issues that will be taken up in a separate procedural track. This determination was based on the recognition that core resource adequacy determinations must be made prior to moving forward with a capacity trading regime or a centralized capacity market.

In an effort to learn from the experience with capacity markets in the Eastern U.S. markets, the Commission sponsored a conference on capacity

markets with the Energy Oversight Board (EOB) and the CAISO in San Francisco on October 4-5, 2004.¹

3. Discussion

I feel that there is potential for the development of an organized capacity market to complement and aid in the effectiveness of the Commission's resource adequacy program in several ways. These include:

- a. A centrally administered residual market could enable ESPs and other LSEs with smaller scale reserve requirements to meet their resource adequacy requirement in a cost-effective manner. For sellers that may not want to transact for very small quantities of capacity, a market could provide a simple, efficient means to sell capacity.
- b. In contrast to pure bilateral markets for capacity, a centralized CAISO residual market could allow for a more effective means of market monitoring and market power mitigation as well as providing a visible market price.
- c. Compared to reliability-must-run (RMR) contracts, a capacity market, especially one with locational attributes, could provide the CAISO with a more cost-effective means to access the resources it needs, without interfering with LSE procurement.²

¹ The topics discussed at the conference included the pros and cons of capacity markets, the role of coordinated markets in supplementing an LSE-based resource adequacy program, whether the ISO should operate a centralized auction for capacity needed to meet capacity requirements, and how and whether centralized capacity markets complement a bilateral resource adequacy approach.

² The Commission has held that RMR contracts should be substantially supplanted by RAR requirements and that the ISO's role in procurement should be minimal. Unlike a capacity based RAR, ISO procurement options, the must-offer, and RMR contracts do not provide for investment in new or existing resources.

- d. A capacity market may provide LSEs with a means of addressing “load migration” concerns and reducing stranded costs by allowing the refining and shaping of capacity procurement quantities and the managing of resource portfolios.
- e. A centralized capacity market may make compliance and enforcement of the RAR more manageable.

Based on these potential benefits that capacity markets may provide, I have requested that Commission staff evaluate how best to pursue an approach to capacity market development. Staff will first develop a discussion paper for review that outlines the advantages and potential problems that must be considered. Among other things, staff will study experiences in the Eastern U.S. markets. In particular, staff will be looking to the New York demand curve approach, as well as a similar approach now being developed in New England.³ The staff evaluation will include a recommendation on defining state and CAISO roles and responsibilities in capacity market implementation. Commission staff intends to complete the white paper for publication in the spring of this year.

Once a model for the approach is refined, the Commission staff will engage the CAISO in discussions to work through an approach that works practically and with the timing of the CAISO market design. The staff will also

³ The New York ISO (NYISO) runs voluntary monthly and six-month auctions. After the monthly auction, the NYISO runs a “spot auction” to meet any unmet needs. The demand curve is only applied to the spot auction. The spot auction provides an administratively-determined price to all bid capacity, based on the intersection of supply bids with the demand curve, such that if supply is below the reserve requirement, the price is higher, and if supply is above the reserve requirement, the price is lower. All supply receives the market-clearing price. The sloped demand curve was established by the New York Public Service Commission and implemented by the NYISO. The state also has a role in establishing the reserve requirement.

make a recommendation on an appropriate process for moving forward with the investigation of capacity markets (e.g., a Commission-initiated OIR, CAISO/FERC-initiated process, or another alternative).

IT IS RULED that parties are placed on notice that the Commission staff is undertaking an evaluation of capacity markets and how development of such a market in California might effectively promote achievement of the Commission's goals for resource adequacy. Whether and how that evaluation will result in a formal Commission proceeding is still under review. For purposes of the resource adequacy portion of this proceeding, it is my intention that actions taken in Phase 2 should allow for the potential development of a capacity market framework.

Dated February 28, 2005, at San Francisco, California.

/s/ MICHAEL R. PEEVEY

Michael R. Peevey
Assigned Commissioner

CERTIFICATE OF SERVICE

I certify that I have by mail, and by electronic mail to the parties to which an electronic mail address has been provided, this day served a true copy of the original attached Assigned Commissioner's Ruling Providing Guidance on Next Steps for Potential Capacity Market Development on all parties on all parties of record in this proceeding or their attorneys of record.

Dated February 28, 2005, at San Francisco, California.

/s/ FANNIE SID

Fannie Sid

N O T I C E

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